

Letter of Findings: 04-20090541
Gross Retail Tax
For the Years 2006 and 2007

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ISSUES

I. Testing Equipment – Gross Retail Tax.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-4-1; IC § 6-2.5-5-3; IC § 6-8.1-5-1; *Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999); *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282 (Ind. Tax Ct. 1999); *Indiana Dept. of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); [45 IAC 2.2-5-8](#).

Taxpayer argues that the Department of Revenue's audit incorrectly found that certain articles of testing and laboratory equipment were subject to sales/use tax.

II. Bulk Rail Loading System – Gross Retail Tax.

Authority: [45 IAC 2.2-5-8](#).

Taxpayer disagrees with the audit determination that equipment used to transport plastic pellets to its loading facility was subject to sales/use tax.

III. Vacuum Pump Carts – Gross Retail Tax.

Authority: IC § 6-2.5-5-3; IC § 6-8.1-5-1.

Taxpayer challenges the audit's decision that the purchase of "custom fabricated carts" was subject to sales/use tax.

IV. Equipment Repair and Replacement Parts – Gross Retail Tax.

Authority: IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#).

Taxpayer protests assessment of sales/use tax on the purchase of what it explains are "repair and replacement parts" for "production machinery and equipment."

V. Carts and Freight Elevator- Gross Retail Tax.

Authority: IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#).

Taxpayer states it is entitled to a sales and use tax exemption on the purchase of "equipment used to transport semi-finished [product] and other mixed and blended materials to the next stage of production."

VI. Safety Equipment and Clothing – Gross Retail Tax.

Authority: [45 IAC 2.2-5-8](#).

Taxpayer protests the assessment of sales/use tax on purchases of various items of safety equipment and safety apparel.

VII. Audit Methodology – Gross Retail Tax.

Authority: IC § 6-8.1-4-2; IC § 6-8.1-5-1.

Believing that the audit's "stat" sample was fundamentally flawed, Taxpayer challenges the audit's methodology employed to compute the additional use tax.

VIII. Negligence Penalty – Tax Administration.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana manufacturer which produces plastic pellets. The Department of Revenue conducted a sales/use tax audit of Taxpayer's business records. The audit began April 2008 and concluded approximately one year later. In addition to reviewing Taxpayer's records, the Department's representative toured Taxpayer's manufacturing facility and also toured Taxpayer's laboratory facility.

As a result of the audit, the Department issued proposed assessments of additional sales/use tax. Taxpayer disagreed with the result and submitted a protest to that effect. After reviewing the Taxpayer's written protest, the Department's Audit Division conducted a supplemental review of the original audit conclusions. This follow-up review included a second on-site visit to Taxpayer's facility. The supplemental review made adjustments to the original findings and issued a report to that effect.

Taxpayer continued to disagree with some of the Department's remaining conclusions. A hearing was held at which time Taxpayer withdrew its protest relating to "business meals." This Letter of Findings addresses the remaining issues which Taxpayer has raised. Additional facts will be provided as necessary.

I. Testing Equipment – Gross Retail Tax.

DISCUSSION

Taxpayer protests the assessment of sales/use tax on "purchases of various pieces of testing and inspection

machinery and equipment which are essential and integral to the [Taxpayer's] integrated production process."

Pursuant to IC § 6-2.5-2-1, a sales tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Retail transactions generally involve the transfer of tangible personal property. IC § 6-2.5-4-1. A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC § 6-2.5-3-2.

Taxpayer apparently invokes as primary authority the "manufacturing exemption" found at IC § 6-2.5-5-3(b). The exemption statute reads as follows:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added).

As a threshold issue, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). IC § 6-2.5-5-3(b), like all tax exemption provisions, is strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Taxpayer points to [45 IAC 2.2-5-8\(i\)](#) as support for its argument that the "machinery and equipment" at issue are exempt. The regulation states, "Testing and inspection. Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt."

The audit disagreed with Taxpayer's contention stating that these particular items of equipment are employed after Taxpayer's production process is complete. As stated in the supplemental report, "Testing and inspecting [Taxpayer's] completed product to see if it meets customer specifications is more a marketing activity." As a result of the testing, "The product is not changed... but is either shipped to the customer or rejected."

The supplemental audit review reconsidered the question of whether the laboratory equipment at issue was exempt but disagreed with Taxpayer's argument on the ground that the laboratory equipment "is used to test raw materials for acceptance or rejection when received at the plant" or used to determine whether completed pellets are or are not shipped to one of its customers.

The issue is whether the particular items of testing and laboratory equipment cited are within or without Taxpayer's production process. Taxpayer asks that the Hearing Officer second-guess the determination of the auditor who had the advantage of visiting Taxpayer's manufacturing facility, touring the production process, hearing an explanation of that process directly from Taxpayer's personnel, and witnessing first-hand the manner in which testing and laboratory equipment was used. The documentation Taxpayer has provided does not overcome this bar.

FINDING

Taxpayer's protest is respectfully denied.

II. Bulk Rail Loading System – Gross Retail Tax.

DISCUSSION

Taxpayer protests the assessment of sales/use tax on equipment used to transport its plastic pellets from one of its production lines to the "de-dusting" equipment located outside the production plant and near the waiting railcars. These railcars are used to transport Taxpayer's plastic pellets to Taxpayer's customers.

The "de-dusting" equipment is used to remove dust from Taxpayer's pellets and to remove "snakeskins" from the pellets. However, this unwanted residue is created when the pellets are moved from the production facility to the railcar location. The residue does not exist at the time the initial production is complete; the residue is created when the finished pellets are moved via pipeline and compressed air to the railcar location.

As authority for its protest, Taxpayer cites to [45 IAC 2.2-5-8\(f\)\(3\)](#). "Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process."

In this case, the Department is prepared to agree with Taxpayer's assertion that this particular equipment is exempt because it is used to move pellets within the production process. Taxpayer's plastic pellets are not "finished" until they undergo the process Taxpayer described.

FINDING

Taxpayer's protest is sustained.

III. Vacuum Pump Carts – Gross Retail Tax.

DISCUSSION

Taxpayer argues its purchase of certain carts is exempt from sales/use tax. The carts are "custom fabricated" and used to support and transport "Busch vacuum pumps and their control panels..." within Taxpayer's

manufacturing facility.

The exemption statute on which Taxpayer apparently relies reads as follows:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added). IC § 6-2.5-5-3(b).

The carts at issue are, according to the Department's audit, mainly used by the Taxpayer's employees to move vacuum pumps from the production line to Taxpayer's service area when the pumps require maintenance or repair. Taxpayer states that the carts also allow Taxpayer to rapidly and conveniently move the pumps between production runs from one line to another – this implies that the carts are not used during the production run. As such, the carts on which the pumps are transported are not directly used in the direct production of Taxpayer's plastic pellets; the carts are ancillary equipment at least one step removed from the "direct" production process. Under IC § 6-8.1-5-1(c), Taxpayer has not met its burden of demonstrating that the carts are used in exempt fashion and that the assessment of sales/use tax was incorrect.

FINDING

Taxpayer's protest is respectfully denied.

IV. Equipment Repair and Replacement Parts & Supplies – Gross Retail Tax.

DISCUSSION

Taxpayer protests the assessment of sales/use tax on what it describes as "various repair and replacement parts" purportedly installed on "production machinery and equipment." Along with these "various" parts, Taxpayer also protests the assessment of tax on "various production supplies that are consumed in the direct production of plastic pellets for sale."

As Taxpayer explains, the "various" parts and supplies are "essential and integral to the direct integrated production of plastic pellets for sale, and therefore, exempt from sales and use tax."

[45 IAC 2.2-5-8](#)(h) contains the authority to which Taxpayer – without explicitly stating as such – apparently relies.

(1) Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

(2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.

The supplemental audit review considered this particular aspect of Taxpayer's protest and concluded that, "Little progress was made on identifying the purchases to which this element of the protest pertains." A second on-site visit by the Department's audit did little to clarify the disputed issue. Subsequent to hearing Taxpayer provided additional description of the protested items on a new expense listing of the pull list ("List").

Due to the fact that a supplemental review had already been conducted by audit, and because the auditor had already visited the plant multiple times, the determination relating to the exempt status of these items is made in this Letter of Findings without an additional supplemental review by audit. Only those items protested by Taxpayer that are most clearly exempt are sustained. Some of the items had no associated description and were therefore disregarded. The page number and "SORT NO." of the items on the LIST deemed exempt are:

Page 1, sort no. 5

Page 2, sort no. 5

Page 3, sort no. 67

Page 6, sort no. 183

Page 14, sort nos. 152, 154, and 157

Page 16, sort no. 203

Page 20, sort no. 49

For the remaining items the Taxpayer did not meet its burden of proving that the original assessment was wrong. IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is sustained in part and denied in part.

V. Carts and Freight Elevator- Gross Retail Tax.

DISCUSSION

Taxpayer disagrees with the assessment of sales/use tax on the purchase of "non-powered four-wheeled carts" and a freight elevator. Taxpayer maintains that the carts and the elevator are used to transport materials from one floor of its manufacturing facility to the "mixing bins" found on yet another floor of the facility.

Taxpayer cites to no specific legal authority for its argument but presumably relies on the exemption cited at [45 IAC 2.2-5-8](#)(f) which states in relevant part:

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

The supplemental audit review, specifically addressing the carts and freight elevator, was unable to agree with Taxpayer's argument that the carts and the freight elevator were exempt. After the second on-site visit, the report found that, "No progress was made on identifying the purchases to which this element of the protest pertains."

Taxpayer operates a large, sophisticated manufacturing facility which undoubtedly contains equipment and processes which are entitled to the cited exemption. However, there are also undoubtedly areas which are outside the "integrated production process" which would preclude Taxpayer from claiming the relief it seeks. Under IC § 6-8.1-5-1(c), Taxpayer is required to prove the original assessment was wrong. In the case of the carts and freight elevator, Taxpayer has failed to do so.

FINDING

Taxpayer's protest is respectfully denied.

VI. Safety Equipment and Clothing – Gross Retail Tax.

DISCUSSION

Taxpayer protested the assessment of sales/use tax on the purchase of safety equipment and clothing which – as Taxpayer describes – "is worn by production operators to prevent bodily injury during the integrated production of plastic pellets for sale."

Certain types of equipment, which constitute essential and integral parts of the integrated production process, are exempt. [45 IAC 2.2-5-8\(c\)](#) "The fact that such equipment may not touch the work-in-progress or, by itself, cause a change in the product, is not determinative." [45 IAC 2.2-5-8\(c\)\(2\)](#). In this case, Taxpayer has cited to legal authority for its protest pointing to the exemption found at [45 IAC 2.2-5-8\(c\)\(2\)\(F\)](#) which provides as follows:

Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

Taxpayer states that it purchased "gloves, earplugs, safety glasses, and steel-toed safety boots..." and that these purchases are exempt pursuant to the cited regulation.

However, the audit did not challenge the fact that certain of this equipment is exempt. Instead, the question faced by the audit was whether the use of these supplies by non-production personnel was or was not exempt. The audit found that the use of the "gloves, earplugs, safety glasses, and steel-toed safety boots..." by non-production personnel – such as administrative and management employees – was not exempt. The audit found a certain proportion of these expenses were related to the production personnel and that items purchased enabled these particular personnel "to participate in the production process without injury or to prevent contamination of the product during production." This distinction was explained to Taxpayer at the time of the original audit. Based on that distinction, Taxpayer provided the original audit with a "worksheet reflecting exempt and taxable use...." Based on that worksheet, the original audit adjusted the assessment; in other words, the original audit found that a certain portion of the items was used in an exempt manner and a certain portion was not. However, the original audit did not make an adjustment for the purchase of safety shoes on the ground that "[t]he production process of this taxpayer did not appear as to be so extreme as to cause the employees production related injury if they did not have safety shoes."

Nonetheless, Taxpayer asks the Department to adjust the percentage of exempt use as determined in the original audit and to reverse the audit's decision that safety shoes – in the context of Taxpayer's particular process – were not needed to enable production employees to complete their work without injury. In this particular instance, the Department is unable to agree that the evidence and information presented is sufficient to warrant adjusting the audit's original determination. The proportion of exempt and non-exempt use was based on Taxpayer's own documentation. Insofar as the safety shoes, the Department's audit – having visited Taxpayer's facility on at least two occasions – was in a far better position to determine whether the safety shoes were necessary for Taxpayer's employees to "participate in the production process...."

FINDING

Taxpayer's protest is respectfully denied.

VII. Audit Methodology – Gross Retail Tax.

DISCUSSION

The original audit report describes the process by which the audit made its original determination. "The taxpayer was set up to have a statistical sample of their January 1, 2006 through December 31, 2007 use tax purchases. The transactions are the purchases other than the assets."

The audit made its determination as to unreported purchases subject to use tax as follows:

The information provided was examined and an error percentage was established for the accounts involved. The error percentage was applied to the account balances involved to establish use tax adjustment amounts. Taxable purchases included equipment to move raw materials and finished goods, laboratory equipment, safety equipment, security equipment, software, clothing, chemicals, fuel, maintenance agreements including

parts, other taxable amounts state separately of unitary transactions such as freight, other machinery equipment and materials not used in an exempt manner.

However, Taxpayer objected to the statistical sample and the particular methodology employed in the original audit. According to Taxpayer's written objection:

[T]he field examiner erroneously listed [capital assets] purchases in his audit report without regard to actual invoices.

Purchases charged to the taxpayer's Construction-In-Process amount are for capital asset projects... [and] should never be included in any sample as these purchases are non-recurring.

[O]ther accounts that have no tax consequence were erroneously included in the account listing for the stratified statistical sample... [including] Training/Education, Meals, and Non-Returnable Packaging.

The stratified statistical sample included non-recurring purchases that should have been treated as extraordinary items and included with a review of capital purchases... [including] lump-sum contracts to improve realty, office remodeling, and asset purchases....

In addition to the above particular objections to items included within the sample, Taxpayer raises objections related to substantive issues such as the question of where and when Taxpayer's production process actually commenced.

After Taxpayer submitted the above objections, the audit reviewed its initial sampling methodology, conducted a second on-site visit to Taxpayer's location, and responded as follows:

Amounts of capital assets purchases are taxable except for those parts of the purchase shown to be exempt by the taxpayer with obligation being on the taxpayer to show exempt purchase or use.

In regards to the non-recurring purchases included within the sample, the follow-up report stated, and "No distortion of adjustment is caused for the items within this stratum." A significant number of items for this protest issue were within this non-projected stratum. Numerous of these capital asset issue items on the stat sample pull listing were removed when [the audit] removed duplicates from the pull listing that were also on the capital asset listing. Of those remaining, some are questionable as to being a capital asset such as the pipe which the taxpayer frequently has to replace as it becomes worn by moving raw materials and finished goods.

Having a purchase posted to a construction in process account or labeled as a capital expenditure alone does not eliminate the purchase from consideration for projection. Mis-classification and grouping of expenditures related to a project but not necessarily capital in nature does occur.

As per [the] computer audit sampling unit, unless the purchasing activity within any of the "no tax consequence" accounts varies wildly from year to year, there would be no problem with their inclusion in the sample population. These "no tax consequence" accounts are basically inflating the denominator which in turn lowers the error rate. This lower error rate is then being applied to a bigger base than would otherwise be the case with the exclusion of said accounts.

The supplementary report concluded that, "The only way to ascertain that the purchases in an account are of no consequence[] is to sample them for adjustable error. Accounts may be suspect for any number of reasons and to exclude an [entire] account based on taxpayer wishes would cause a scope limitation. This taxpayer reflected little use tax paid and did not have accounting that appeared to be familiar with use tax regulations."

The Department may, of course, examine the books, records, or other data bearing on the correctness of the returns and to arrive at a rational conclusion based on those records. IC § 6-8.1-4-2. As noted above, the notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC § 6-8.1-5-1(c).

The Department agrees that a recalculation of taxpayer's sales and use tax liabilities could very well result in a different result than the one reached by the audit. However, an administrative hearing is not the appropriate forum by which to explore variances and suggest alternative methodologies. Having protested the audit results, it is the taxpayer's burden of demonstrating that the sampling method is wrong, not that an alternative methodology would produce a different result. Taxpayer asks the Legal Division to intrude on an area of expertise of which the Legal Division has little experience and for which Taxpayer has no legal challenge. Taxpayer has submitted various technical observations questioning the audit methodology and the audit has replied in a reasonable manner. Taxpayer has failed to demonstrate clear error on the part of the audit.

FINDING

Taxpayer's protest is respectfully denied.

VIII. Negligence Penalty – Tax Administration.

DISCUSSION

The Department issued ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

The Department refers to [45 IAC 15-11-2\(b\)](#), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or

diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in [45 IAC 15-11-2\(c\)](#), as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer has met its burden of proof to show that the deficiencies they incurred are due to reasonable cause and are therefore not subject to a penalty under IC § 6-8.1-10-2.1(a).

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer is sustained on Issue II, "Bulk Rail Loading System" and Issue VIII, "Negligence Penalty."

Taxpayer is sustained in part and denied in part on Issue IV, "Equipment Repair and Replacement Parts & Supplies."

Taxpayer is denied on all the other protest issues: Issue I "Testing Equipment," Issue III "Vacuum Equipment," Issue V "Carts and Freight Elevator," Issue VI "Safety Equipment and Clothing," and Issue VII "Audit Methodology."

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